

## THE INSTITUTIONAL CHANGE AND IT'S IMPLICATIONS ON ECONOMIC DEVELOPMENT

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### Abstract

*The guide in the elaboration of this article was the work of the famous attorney of the new institutionalism, D. North, named "Institutions, Institutional Change and Economic Performance".*

*His central idea was focused on the retaining wall of the necessity of an institutional change that to permit the economic performance. The author observes that the productive activity depends in an essential way by the institutionalization on property rights and by the observance of the contracts. If a system of property is institutionalized in a good manner and in same time he's stable, then we can talk about by a fosterage of the investments on a long term, in these way facilities the productive activity. On the contrary, when the property is affected by risks and raised costs, the peoples will be attracted to the direct gaining based on speculation and on the obtaining of one fairly substantial part by the property existing already.*

*Considering all these, our step try to astound, essentially, the reasons for that the structures of governance must refer at an institutional change in a state, change that must generate the economic performances.*

Nowadays, the study concerning *the institutions* and their impact on economic growth and development represent an important research theme for the contemporary economists.

Why and how do institutions change? How do institutions persist in a changing environment and how do processes that they unleash lead to their own demise? At all these questions we will try to find some answers.

Development of the game theoretic perspective on institutions thus requires extending it to studying institutions as a product of an historical process in which institutions endogenously change. Furthermore, doing so will enhance integration of this perspective with complementary perspectives, such as that of institutional *path-dependence in economics* [North, D., 1990, David, P., 1994, Greif, A., 1994] which says that the institutions from past and the institutional elements are a part of the medium who implies the processes that go to the creation of the new institutions.

After many decades of economic deprivation and political oppression, socialist regimes in the countries of Central and Eastern Europe withered away by the end of 1980 years. The end of socialism created an opportunity for people in these countries to develop better institutions. Indeed, new leaders in the region immediately announced plans for institutional restructuring. In the early 1990s,

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most citizens seemed willing to bear the cost of transition, and free-market ideas enjoyed significant political capital.

The transformation of the Central and Eastern Europe countries socialist economies into capitalist-or free-market, private-property- economies was the new leaders' major stated objective in the early 1990s<sup>1</sup>. Conceptually, genuine capitalism is institutionalized as prescribed by the doctrines of classical liberalism. Its main traits are the rule of law, constitutional democracy, and open markets<sup>2</sup>. The rule of law, which the constitution embodies, guarantees stability and credibility of private-property rights, contractual freedom, and an independent judiciary. Those institutions, often seen as guarantors of so-called *negative rights*, protect individual members of the community from being forced by a majority rule, decision makers in government, labor unions, and other rent-seeking groups to subordinate the pursuits of their private ends to a desired outcome.

James M. Buchanan observes: „ in a rule-of-law state there is an explicit prejudice in favor of previously existing rights, not because this structure possesses some intrinsic ethical attributes, and not because change itself is undesirable, but for the much more elementary reason that only such prejudice offers incentives for the emergence of voluntary negotiated settlements among [individual members of the community] [Buchanan, J. 1975, p. 52]. Open markets reflect a network of contractual rights and possibilities based on the rule of law and constitutional democracy. In a world of bounded rationality, open markets provide freely choosing individuals with strong incentives spontaneously to develop, try and accept institutional arrangements („rules of the game,„) that minimize the transaction costs of voluntarily (1) letting resources find their highest-valued uses and (2) accepting the risk associated with the development (innovation) of new opportunities for exchange.

In others words, the institutions that offer greater incentives for voluntary interactions are more efficient than institutions that provide fewer options for free exchange.

The neoclassical type of thinking explain so-called „trinity of the transition process“: the macroeconomic stability, the privatization and the liberalization of prices.

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<sup>1</sup> Although some leaders in Central and Eastern Europe countries believed in the transformation to capitalism, others misunderstood the implications (costs) of capitalism, and still others merely paid lip service to the transition to capitalism in order to please the West and local free-market parties.

<sup>2</sup> The *rule of law* means absence of arbitrary power on the part of the ruling group; subjection of all citizen to the same stable and credible laws, also, to the democratic elections. The absence of discretionary power means that no rule is to be enacted with the intent of helping or harming particular individuals.

Institutional reorganization supposes a destabilization of the rules of community. The politics that over impose the objective of the macroeconomic stability through institutional reorganization can be explained only by the neoclassical suppositions which affirm that it's creating new equilibrium momentary or that it's possible the good adjustment of the economic processes by the govern.

If in the '80 years the option by neoclassical type was for „the retired state,, and for the affirmation of the civil society, at the beginning of '90 years the attention was focused on the role of institutions which can accelerated or stop the development. Since of the beginning of XX century, the attorneys of the old institutionalism T. Veblen and J.R. Commons criticized the economic theories for the ignorance of the role of institutions in the development [Veblen, T., 1948, Commons, J.R., 1961]. This „old institutionalism'' it wasn't resume than later by the economists , through „the new institutionalism'' for analyze the emergence of the markets, the property rights or the state but, especially for explain the differences between the economic performance of the nations.

In other way, the fundamental question is formulated something like that: how can be explaining these differences between the economic performances of the developed states and the underdeveloped states?

Is obviously for everyone that the gap between the riches nations (developed) and those that are poor (underdeveloped) has the tendency to conserve themselves and especially to grow. Afterwards, some states hold for a long period in a stagnation form or economic decline while others states advanced them permanently on the way of the accumulation of wealth. Again, the question is: how can be explaining these divergent tendencies? The theoretical response at all these questions supposed, at the beginning of '90 years, a contest of the neoclassical economic theories and an invocation of the institutions<sup>1</sup> and organizations like explanatory factors of the economic performances. The assumption of this approach is that the models of development, economically or politically, are specific of one institutional context that is the property to vary in function by the historical time or by the geographical space. In consequence, it can't exist an universal model of the development but only institutional alternative models. The institutional constraints has the mission to establish the different type of organizations (firms, trade-unions, political parties), all of these acting in the directions that bringing them maximum of satisfaction [Vlăsceanu, Lazăr, 2001, p. 56].

Accordingly, to analyze the conditions and the frame of the development means to consider the formal and informal rules that regulate the rapports between

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<sup>1</sup> *The institutions* are sets of formal rules (laws, juridical norms, contracts) or informal (values and social norms) that settle the actions of peoples or of organizations and the interactions between the participants at a development process.

the social actors and the organizational frames within they unfolded the activity. These rules aren't only compelling but also incentive, namely not fix only the limits of the activities or exchanges but they are the rewards that can be obtain in a known frame.

Thus, researching the history of the development of different economies, C.D. North affirms: „if the organizations [...] dedicate their efforts on the *unproductive activity* then the institutional constraints offer a structure of incentives for an activity like this one” [North, D. 1990, p. 92] .

The countries of the third world are poor because „the institutional constraints define a set of recompenses of the political/economical activity that not encouraged the productive activity [North, D. 1990, p. 110]. In this direction, C.D. North compares the American economy of the XIX century with the economy of the contemporary countries in development to set off the institutional differences and their divergent effects. The institutional frame that appeared in USA at the beginning of XIX century (*The Constitution*, *The Northwest Ordinance* and the norms by comportment that remunerate the supported labor) would have gone at the development of those political and economical organizations that was centered on the supported labor, productivity, saving, investment and valuing the education. In this context of formal and informal opportunities appeared those organizations that had followed to benefit by stimulants and recompenses available, concomitantly making more powerful the prevalent institutions and continuing their development [Vlăsceanu, Lazăr, 2001, p. 57].

The economic growth was constantly induced by the institutional frame that stimulated the organizations to engage in the productive activities. If we report us at the countries in development we can see that here the institutional frame is a mixture that generate two kinds of opportunities (productive and redistributive) for the political and economical contractors.

In opinion of North, the institutional frame works, in the underdeveloped countries, in a manner that „favored the activities that promote specially redistribution not production, that create monopolies not the conditions of competitiveness and that restrict not extend the opportunities [...]. The organisations that developed in this institutional frame will become more efficient – but they will be more efficient in to make the society more unproductive and the basic institutional structure more generator by unproductive activity. This direction can persist because the transaction costs of the political and economical markets of these economies together with the subjective models of the actors not conduct them to results more efficient “[North, D. 1990, p. 9].

The institutions are identified with „constraints on behaviour in the form of rules and regulations” [North, 1981, p.18]. Culture is important to the extend that „moral and ethical behavioural norms aimed to reduce enforcement costs [Levi, M.,1988, p.47].

The new institutionalism examined the variety of institutions but the micro-

economic theories it utilize – transaction cost economics, the theory of property rights and public choice theory – constrained most of its historical analyses to institutions defined and enforced by the state

[Alston, L., and Higgs, R., 1982, p. 28]. This historical analysis is guided by three deductive assertions [Davis, L. and North, D., 1971, p. 19]. *First*, institutions defined and enforced by the state – property rights, rules and regulations- determine economic performance through their impact on transactions costs. *Second*, the economic implications of a given institution change over time due to technological change, population growth, market integration, and other factors. Therefore, the economic outcomes depend on efficient institutional change. Furthermore, the specialization increases transaction cost (holding institutions constant) implying that institutional change is even more important in advanced economies [Wallis, J., and North, D., 1986, p. 126]. *Third*, the institutions are usually inefficient since they are determined through a political process and are influenced by the transaction cost of bargaining.

We consider that the acknowledgement of the importance of the institutions which determine economies to work properly: *private property, contract, free market*. The government structures, which decide in an economy, must make every effort to take the necessary measures to protect a fundamental right, the one to private property, and to try to shape a conception typical for a democracy and free economy.

In the last decades we are witnessing a series of phenomena and processes which characterize mankind evolution and indicates the fact that we are facing a period of profound transformations. Therefore, we argue the idea that economic and social transformation can be conceived only through the specific institutions of market and economic development. The question that raises is: which are the institutions that count in the transition process? How can a communist economy be transformed in a performant market economy? At a first analysis we can state that the most important institutions are those related to the right and protection of property, economic adjustment, macroeconomic stabilization, social protection and the conduct of enterprises in a competitive environment. Yet, the simple realization of them, but without respecting the principles of economic development and the European frame of development, means an effort which could cost Romania another 50 years of attempts and failures.

We emphasize that the differences between national economies of different states concerning growth and development of the economy are given by *the level of development and particularism of the institutions*.

The institutions model the behaviour oriented to accomplishing of some economic objectives. But this becomes possible only if there is compatibility between these objectives and the institutional-cultural values that enable the achieving of them [Thomas, C., Daniel, 2005, p.56].

The institutional measures, the acknowledgement of the property right, the transformation of the state enterprises in capital companies, the privatisation of the public-owned assets, the right of establishing companies, the law of bankruptcy, the adopting of an investment code became the foundation of the new market economy

[Lovell, W. David, 2002, p.32]. The modern institutions differ from all types of social order by their dynamism, by the extent that they undermine the traditional habits and by their global impact.

The reorganization that we assist now, suggests that the actual mutations are equivalent to a radical change of the paradigm. The institutions from a society demonstrate the strongest change resistance. The transformation of the institutions would favorably affect the reaction of individuals and organizations. The institutions and their adaptability are the most that matter for explaining the different growth rates and economical development [North, Douglas, 1990, p.42].

Taking into discussion the case of Romania, after 1989 the emphases fall over the privatizations of the activity of the economic agents, the liberalization of using of the economic levers, the adopting of a series of macroeconomic politics that favored the reorganization of the production according to the economic effectiveness principle.

The reorganization by privatization has arisen numerous controversies and is the subject of a permanent dispute in theory. Romania has known during the past decade an economic decline, being positioned after 1985 in the economic decreasing area that profoundly accentuated after 1989. The complex process of reorganization at the micro level as well as the macro level requires *immense social costs* hard to be supported by the population. The expected investments were quite reduced; no flux of competitive technique and technology has been produced by the new owners. *The investments* that have been made were especially focused on light industry, the food industry, trade and tourism, sectors in which the possibility of investment recovery is more probable. So the reduced investment attracted a high rate of unemployment fact with considerable implications in economic development of our country.

In the actual world economic context, Romania must not only to become a functional state in the competitive economic system of market economy but it must give priority to the economic sectors, its branches and subbranches in the direction of orienting of the national economy through those branches that are not consuming big amounts of natural resources and that offers the possibility of capital accumulation in a short time for this accumulation to be reinvested, so the national investment flux, capable to revitalize the economy to be assured and this to assure also the growth of the living standard of the population.

The institutional analyze demonstrated that the rhythm and the direction of the development are historical dependent, and the discrepancies in the history, through revolutions, not eliminate totally the path dependence<sup>1</sup>, namely by history and will survive and perform the most efficient institutions in the reduction of transaction costs (the capitalist firm for example).

Thus, in a functionalist vision, the institutions, like *incentive alignment* or *governance structures* are the result of the efforts that suppose to minimize the transaction costs. The institution of the modern firm capitalist is, in the opinion of Williamson, the guerdon of *economizing on transaction costs* but not to one historical process of path dependence or of the exploitation of the workers by the capitalists [Williamson, O., 2002, p.37]. The

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<sup>1</sup> *The path dependence* means that the institutions existing at a given moment are in a considerable manner determinate by the precedent institutions, resulting an incrementalist historical evolution

holders of capital had become the owners of the firms who economizing transaction costs but not because of history [Păunescu, Mihai, 2002, p.38]. In the support of these can come so-named „state of development”, namely that state in which „the politic concentrated many power, autonomy and capacity at the central level for model, apply and encourage the realization of one explicit objectives of development, or through the establishment or the promotion of the conditions and direction of economic growth, or through the direct organization of these, or through a mixture of both” [Leftwich, Adrian, 1995, p. 12].

We consider that the institutional change is a necessity in a state for generates de economic performances only if this realizing and imposing concordantly with the just, ethics and morals rules of the society.

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